TOWARDS A EUROPEAN SOCIAL TAXONOMY: A SCORECARD APPROACH

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Abstract

This paper analyzes the EU's efforts in designing a social taxonomy for sustainable investments. Examining the draft Social Taxonomy proposed by the Platform for Sustainable Finance in early 2022, we challenge the decision to follow the methodology provided by the EU's environmental taxonomy detailed in the Taxonomy Regulation. We criticize in particular its "winner takes all" character whereby only economic activities meeting both furthering and facilitating characteristics and the do-no-significant-harm (DNSH) principle – as narrowly defined by a set of Technical Screening Criteria adopted in Level 2 legislation – can be classified as sustainable. Furthermore, the environmental taxonomy methodology seems to fail to properly incentivize transitional and mitigating economic activities, prompting the need to adopt an additional classification system for that purpose. Despite countless words, taxonomy rules remain incomplete and occasionally vague. This regulatory complexity carries enormous transaction costs for issuers, advisors and financial institutions. This observation casts doubt on the ability of the taxonomy framework to support the transition into a sustainable EU economy.

Contemplating these deficiencies, we propose an alternative scorecard approach assigning lower scores for transitional and mitigating activities and higher scores for activities meeting stricter taxonomy system criteria. While we admit that this might lessen accuracy for some aspects, the advantage of a scorecard approach lies in its adaptability and indicative effect, putting an emphasis on economic activity's transition towards sustainability.

Keywords: social taxonomy, environmental taxonomy, sustainability, ESG

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I. Introduction

Sustainability entails considering environmental, social and governance (ESG) factors to further long-termism in social and economic activities. Sustainable investments finance such activities.[1] In turn, sustainable finance can be understood as 'the process of taking due account of environmental and social considerations in investment decision-making, leading to increased investments in longer-term and sustainable activities,' whereas 'social considerations may refer to issues related to inequality, inclusiveness, labour relations, investment in human capital and communities.'[2]

Recently, environmental sustainability has been climbing up policy-makers' agendas. Meanwhile, social sustainability has been recognized as a core issue in European treaties,[3] standards,[4] and declarations of commitment.[5] References to social sustainability are in international standards on sustainability and agreements, including the Paris Agreement. The importance of social sustainability has also been reaffirmed in the context of the EU Sustainable Finance Action Plan (hereinafter SFAP)[6] and the EU Strategy for Financing the Transition to a Sustainable Economy.[7] Despite numerous statements on the importance of *social* sustainability, however, the current European legal framework focuses almost entirely on *environmental* sustainability. Yet, if one of the SFAP's aims is to reorient capital flows to achieve sustainable and inclusive growth, then socially-sustainable investments cannot be disregarded; while

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[1] In economics literature, the term sustainable investment is often used as an overarching term to indicate sustainable, responsible and impact investing, see H. Liang and L. Renneboog, *Corporate Social Responsibility and Sustainable Finance: A Review of the Literature*, ECGI, FINANCE WORKING PAPER N. 701/2020 (2020). In some cases, the terms sustainable investment and socially responsible investments (SRIs) are used interchangeably, see J. Sandberg et al., *The Heterogeneity of Socially Responsible Investment*, 87 JOURNAL OF BUSINESS ETHICS 519, 519–533 (2009). In practical terms, making sustainable investments implies the incorporation of ESG factors into the investment decision-making process, see GLOBAL SUSTAINABLE INVESTMENT ALLIANCE, GLOBAL INVESTMENT REVIEW (2016), https://apo.org.au/sites/default/files/resource-files/2017-03/apo-nid228336.pdf.

[2] EUROPEAN COMMISSION, ACTION PLAN: FINANCING SUSTAINABLE GROWTH (3 Mar. 2018), COM/2018/097 final.

[3] Art. 3.3 and 21 of the Treaty on the European Union (TEU).

[4] European Social Charter and the European Pillar of Social Rights.

[5] Concluding Report on the Social Summit for Fair Jobs and Growth, Commission Recommendation for Effective Active Support to Employment (EASE), European Pillar of Social Rights Action Plan, Porto Social Commitment, The Porto declaration. Lisbon Declaration on the European Platform on Combatting Homelessness.

[6] See n 2.

[7] See European Commission, Strategy for Financing the Transition to a Sustainable Economy, COM(2021) 390 final, 6 July 2021.

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environmental sustainability focuses on short-term effects on the environment, socially-sustainable investments address the root cause of such short-termism, by equipping business actors and societies to think long-term and secure a stable social environment. The need to finance social, alongside environmental, concerns cannot be underestimated: the resources needed to achieve the Sustainable Development Goals (SDGs) of the UN's 2030 Agenda amount to an estimated USD 2.5-3 trillion annually.[8]

At EU level, discussions on whether and, possibly, how to design a social taxonomy are ongoing, with it currently being left to investors to define the content and characteristics of social investments. However, the resources invested in social bonds and microfinance have increased considerably lately.[9] The COVID-19 pandemic has amplified the need for private capital to fund basic social needs.[10] Such increasing demand has been followed by greater social investments, signaling growing interest in the market. Social bond markets reached a value of EUR 220 billion in 2020, rising by 1000% compared to 2019.[11]

Already in 2018, the European Commission committed to publish a report on a social taxonomy by 2021[12] and appointed the Platform on Sustainable Finance (hereinafter PSF) to advise, *inter alia*, on a possible extension of the taxonomy to address other sustainability objectives, including social objectives.[13] In its revised Sustainable Finance Strategy of July 2021,[14] the European Commission underlined that a social taxonomy would be key to steering capital flows towards economic activities improving living standards and working conditions as well as human rights protection. Similar to the environmental taxonomy, the European Commission intends to establish widely-accepted definitions and measurement methods concerning socially-sustainable conduct and activities to tackle "social washing", whereby conduct is promoted as socially sustainable despite not aligning with the SDGs.

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[8] www.un.org/sustainabledevelopment/sg-finance-strategy/.

[9] PricewaterhouseCoopers, ESG Transformation of the Fixed Income Market, 2022, www.pwc.lu/en/sustainable-finance/docs/esg-transformation-fixed-income-market.pdf (social bonds reached Eur 130 billion in 2021 from Eur 6.2 billion in 2019 of new issuances and are forecasted to double by 2026 in the European market).

[10] See Dirk A. Zetzsche and Roberta Consiglio, Ten Million or One Hundred Million Casualties? – The Impact of the COVID-19 Crisis on the Least Developed and Developing Countries and Europe's Sustainability Agenda, in B. Sjåfjell, G. Tsagas and C. Villiers (eds), Sustainable Value Creation in the EU: Towards Pathways to a Sustainable Future through Crises (Cambridge University Press, forthcoming 2022).

[11] Climate Bonds Initiative, Record $700bn of Green, Social & Sustainability (GSS) Issuance in 2020: Global State of the Market Report (Apr. 23, 2021).

[12] Art. 26(2)(b) of Taxonomy Regulation.

[13] Art. 20(2)(j) of Taxonomy Regulation.

[14] See n 7.

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In February 2022, the PSF published its Final Report on Social Taxonomy,[15] advancing some proposals on how to design such a taxonomy and revising some of the structural features discussed in the Draft Report on Social Taxonomy published in July 2021.[16]

This paper critically discusses the main features of the proposed social taxonomy, reflecting on its deficiencies and proposing an alternative scorecard approach assigning lower scores for transitional and mitigating activities and higher scores for activities that meet stricter criteria. While this might reduce accuracy for some aspects, the scorecard approach would have greater adaptability and an indicative effect emphasizing the transition of an economic activity towards sustainability. Addressing these issues, this paper is divided into five parts. After this introduction, Part II outlines the content of the social taxonomy, Part III discusses the strengths and weaknesses of the taxonomy methodology proposed so far, Part IV presents our scorecard approach, and Part V concludes.

II. Social Taxonomy as a Derivative of the Environmental Taxonomy

The European Commission requested the PSF to explore the extension of the taxonomy to cover social objectives. The PSF first published a draft report on social taxonomy in July 2021, highlighting the need for a social classification system to ensure comparability.[17] While the PSF originally devised a more complex setting,[18] the final report presented a new structure based on three social objectives and a methodology similar to the Environmental Taxonomy, including the concept of substantial contribution (to the achievement of one or more social objectives), akin to Art. 9 of the Taxonomy Regulation, along with the DNSH principle for the other social objectives (similar to Art. 17 of the Taxonomy Regulation).

1. The social objectives

The three social objectives taken from international standards and previous work at EU level[19] refer to: 1) decent work,

[15] PSF, Final Report by Subgroup 4: Social Taxonomy, February 2022, https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/280222-sustainable-finance-platform-finance-report-social-taxonomy.pdf.
[16] PSF, Draft Report by Subgroup 4: Social Taxonomy, July 2021, at 4, https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/sf-draft-report-social-taxonomy-july2021_en.pdf.
[17] Id.
[18] In particular, the PSF suggested a horizontal and vertical dimension of social objectives.
[19] Such as the European Social Charter and the European pillar of social rights.

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including with respect to value-chain workers; 2) adequate living standards and wellbeing for end-users; and 3) inclusive and sustainable communities and societies.[20]

These objectives embed a number of different rights, ranging from civil rights to political rights as well as economic, social and cultural rights, which are interdependent and indivisible. They have been identified by inspecting stakeholders whose rights are potentially affected by economic activities. Stakeholders potentially affected are: 1) an entity's own workforce (including value-chain workers); 2) end-users or consumers; and 3) communities (directly or through the value chain).[21] Accordingly, the decent work objective mostly refers to workers, while the adequate living standards and wellbeing for end-users objective mainly relates to consumers and the inclusive and sustainable communities and societies objective clearly focuses on members of communities.

Yet, as the three social objectives embrace diverse aspects and characteristics, the creation of sub-objectives has been regarded as an effective way of better defining the former to ensure their successful achievement. Sub-objectives need to meet two requirements, namely that they cover all essential components of the objective and that they are clearly distinguishable from each other without overlaps.[22] The PSF also underlines that while an economic activity will not be requested to substantially contribute to every sub-objective of a given social objective nor to several objectives simultaneously to qualify as sustainable, this would still be possible in practice.[23]

[20] See n 15.
[21] Id., stating that centring the social taxonomy around these three stakeholders would ensure more simplicity.
[22] Id.
[23] Id.

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Table 1: Social objectives and sub-objectives

SOCIAL OBJECTIVES AND SUB-OBJECTIVES		
1. Decent work, including with respect to value-chain workers	**2. Adequate living standards and wellbeing for end-users**	**3. Inclusive and sustainable communities and societies**
1.1 Promoting decent work	2.1 Ensuring healthy and safe products and services	3.1 Promoting equality and inclusive growth
1.2 Promoting equality and non-discrimination at work	2.2 Designing products to be durable and repairable (making spare parts available, ensuring the interoperability of spare parts with those of competitors) and offering services that allow for a smooth multimodal experience (e.g. in transport)	3.2 Supporting sustainable livelihoods and land rights
1.3 Ensuring respect for human rights and workers' rights in the value chain	2.3 Providing for cybersecurity and the protection of personal data and privacy	3.3 Ensuring respect for human rights of affected communities by conducting risk-based due diligence
	2.4 Engaging in responsible marketing practices by providing all relevant and comprehensible information to consumers so they can make informed choice, and avoiding directing consumers towards products and services not in their interest	
	2.5 Ensuring access to quality healthcare products and services including care services (these should have a high standard of quality and safety, and be easily accessible)	
	2.6 Improving access to healthy and highly nutritious food especially for children	
	2.7 Improving access to good-quality drinking water	
	2.8 Improving access to education and lifelong learning	

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a) Decent work

The first objective, taken from the SDGs and the ILO's agenda, is decent work, including in relation to value-chain workers. This objective is based on four pillars: 1) employment creation; 2) social protection; 3) rights at work; and 4) social dialogue. Identifying them has enabled the PSF to set 3 sub-objectives which are further detailed in table 2.

The PSF stresses that this objective should have a global scope on the grounds that in non-EU countries decent work conditions are sometimes not guaranteed. To ensure this objective has a global reach, the entire supply chain is covered irrespective of where the suppliers reside.

Table 2: Sub-objectives of "Decent Work"

DECENT WORK		
1.1 Promoting decent work	1.2 Promoting equality and non-discrimination at work	1.3 Ensuring respect for human rights and workers' rights in the value chain
Enhancing social dialogue	Equal employment opportunities for women and workers from different backgrounds	No further specification
Promoting freedom of association and collective bargaining	Creating jobs for women	
Ensuring that pay levels for workers are determined in a predictable and transparent way so living wages guarantee decent living for workers and their families	ensuring that the pay gap between executives and the average worker is not excessive	
Providing health and safety of workers	Ensuring a living income for farmers	
Running training programs		
Providing social protection through pensions and welfare		
Preventing forced labor, exploitation, and child labor		

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b) Adequate living standards and wellbeing

The second objective concerns adequate living standards and wellbeing for end-users, focusing on end-users of products and services that either create heightened health or safety risks or have the potential to help them meet basic human needs.

This objective is further specified by various sub-objectives emphasizing consumer protection and economic and social rights as shown in table 1.

c) Inclusive and sustainable communities and societies

The third objective addresses inclusive and sustainable communities and societies, centering on human rights against the backdrop of the impacts of economic activities on communities and societies. It treats people as members of wider communities and society at large.

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Table 3: Sub-objectives of "inclusive and sustainable communities and societies"

INCLUSIVE & SUSTAINABLE COMMUNITIES		
3.1 Promoting equality and inclusive growth	3.2 Supporting sustainable livelihoods and land rights	3.3 Ensuring respect for human rights of affected communities by conducting risk-based due diligence
Improving access for target populations and/or areas to basic economic infrastructure such as transport, telecommunications, financial services, and electricity	Promoting community-driven development where decision-making processes are decentralized to community level	Interacting with indigenous people potentially affected by economic activities
Childcare and support for children	Avoiding and addressing negative impacts on communities from business operations, regarding, *inter alia*, land and livelihoods, health, safety and security, sacred sites, and access to basic services	Supporting freedom of assembly and expression, including the protection of human-rights defenders and civic space
Inclusion of people with disabilities	Meaningful consultations with affected communities, including on development priorities, with a view to ensuring continuous engagement and good-faith negotiation with indigenous peoples to obtain their consent before undertaking any activities that may affect them	
Creating and preserving decent jobs as part of a just, green and digital transition (e.g. by retaining and reskilling workers)		
Preserving employment levels, hiring local workers, and supporting local suppliers in targeted areas		
Promoting equality by addressing recognized gender gaps in communities and society or having a transformative impact on gender equality and time-saving for women		

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2. Substantial Contribution

a) Borrowing from the Environmental Taxonomy

As is the case in the environmental taxonomy, economic activities are to substantially contribute to at least one social objective to be labelled as sustainable. Thus, the substantial contribution requirement ensures that only economic activities meeting high social standards (i.e. substantially contributing to one or more social objectives) can qualify as socially sustainable. This mechanism is expected to incentivize businesses (in terms of access to financing) to rethink how they carry out economic activities and revise them to substantially contribute to social objectives.

Mirroring, to some extent, the environmental taxonomy's structure, a substantial contribution to one or more social objectives can be made in three different ways, namely: 1) by avoiding and addressing negative impacts; 2) by enhancing the positive impact inherent in economic activities; and 3) through enabling activities.

Importantly, the PSF suggests that substantial-contribution criteria be developed and assessed at sub-objective level. This also calls for the development of precise criteria against which substantial contribution is measured.

b) Social goods, services and infrastructure

The Social Taxonomy understands the positive impact inherent in economic activities as a substantial contribution to 'adequate living standards' and 'wellbeing for end-users and inclusive and sustainable communities and societies.'[24]

Several economic activities provide inherent social benefits for end-users, communities, and societies, thereby contributing to social objectives. This can entail providing affordable pharmaceuticals to certain groups of people or providing access to housing and healthcare. Such activities are needed to reach adequate living standards and ensure protection of economic, social, cultural, and human rights. Accordingly, such economic activities are said to have inherent social benefits.

Since basic human needs are not always satisfied, criteria for measuring this type of substantial contribution should be designed so capital can finance businesses trying to provide goods, services, and basic economic infrastructure that are not otherwise accessible or available.

[24] Id.

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c) Considering negative impacts

In the substantial contribution concept, every related negative impact arising from such a contribution becomes key to the effectiveness of the social taxonomy.

Avoiding and addressing negative impacts closely concerns workers, communities, and end-users. The underlying idea is that economic activities avoiding and addressing negative impacts on these stakeholders should be seen as potentially making a substantial contribution to social objectives. Special attention here is paid to economic activities within high-risk sectors with documented human-rights and labor-rights abuses as well as within sectors less likely to contribute to relevant objectives. This is based on the consideration that, as recalled by the UN Office of the High Commissioner on Human Rights; 'for businesses, the most powerful contribution to sustainable development is to embed respect for human rights in their activities and across their value chains, addressing harm done to people and focusing on the potential and actual impacts.' In this respect, the goal is to encourage businesses to avoid and address potential and actual negative impacts on human rights from their economic activities, thereby bringing social improvements. Yet, an appropriate design of the substantial contribution concept is crucial to ensure that only those economic activities meeting high standards related to impacts on human rights as well as due-diligence and risk management processes qualify as substantially contributing to a social objective. Attention must be paid to the ability of these economic activities to generate meaningful outcomes in terms of human-rights protection for different stakeholders.

On these grounds, the social taxonomy intends to provide businesses with incentives to revise the way their economic activities are performed so human rights of workers, communities, and end-users are safeguarded. The incentive offered is the possibility to more easily access capital from investors interested in making socially-sustainable investments. Moreover, the social taxonomy should help businesses understand how to revise their economic activities to make a substantial contribution to a social objective. Such help is given through the development of precise criteria against which substantial contribution is assessed.

d) Enabling activities

Enabling activities potentially improve social performance of other economic activities without substantially contributing themselves to a given social objective. There are enabling activities for all three objectives, including social auditing services helping to reduce negative impacts on value-chain

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workers. Other examples relate to setting a complaint mechanism acceptable for all parties and conducting tests to discover harmful substances in consumer products.[25]

3. The 'Do No Significant Harm' principle

Mirroring the environmental taxonomy provisions, the DNSH principle aims to ensure that an economic activity substantially contributing to a social objective does not harm any other social objectives.[26] Otherwise, such an economic activity should not qualify as socially sustainable despite its substantial contribution to a social objective.

On the grounds that substantial-contribution criteria will be developed and assessed at sub-objective level, for consistency purposes the PSF suggests that DNSH criteria be developed at the same level too. Yet, this might lead to a situation where an economic activity is assessed for both substantial contribution and DNSH against the same objective(s) and potentially the same sub-objective(s).[27]

The PSF emphasizes the importance of DNSH criteria with particular regard to sub-objectives in relation to which defining substantial-contribution criteria might result in complications because of practical difficulties in prioritizing sectors or in linking turnover and/or expenditures to economic activities.

It has been pointed out that there might also be cases where a social factor can be linked to an activity but sector selection proves difficult. Here, generic DNSH criteria linked to the activity, rather than the entity, might be applied. Such criteria would have the same wording for all activities identified in the social taxonomy and would be more detailed than minimum safeguards.

The Social Taxonomy defines, as socially harmful activities, activities fundamentally opposed to social objectives and which cannot be made less harmful. The legal basis on which activities qualify as socially harmful could be either internationally-agreed conventions or research on the detrimental social effects of

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[25] Id.

[26] Id., providing a number of examples in this regard, such as, 'broadband expansion in under-served areas makes a substantial contribution to the objective of inclusive and sustainable communities and societies. However, broadband expansion should not harm the rights of workers building the broadband infrastructure and the living standards and well-being of consumers using the internet services'.

[27] Id., providing the example of 'an economic activity that makes a substantial contribution to living wages (thus promoting the decent-work objective)', which at the same time, 'should not: (i) harm equal employment opportunities for women; (ii) undermine collective bargaining processes; or (iii) use child or forced labour in supply chains, etc. (all three of these are sub-objectives under the decent-work objective)'.

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certain activities. For the former, relevant international conventions are for example those on certain weapons. Regarding the latter, research on detrimental health effects of tobacco could be a reason to classify the production and marketing of cigarettes as significantly harmful.

The PSF also emphasizes that activities described as always harmful in one taxonomy (e.g. coal-fired power generation in the Environmental Taxonomy) should also be excluded from any taxonomy.[28]

4. Minimum safeguards

As in the environmental taxonomy, minimum safeguards aim to ensure that some environmental and social minimum requirements are met by economic activities for them to qualify as socially sustainable. However, while in the environmental taxonomy minimum safeguards only relate to social standards, in the social taxonomy both social and environmental considerations are relevant.

Firstly, mirroring the environmental taxonomy, environmental minimum safeguards must be identified and complied with by economic activities aiming to qualify as socially sustainable. Accordingly, social sustainability is not achieved to the detriment of the environment. Environmental minimum safeguards can be taken from the environmental part of the OECD Guidelines.

Nonetheless, social minimum safeguards might be needed too. There are indeed certain social objectives in relation to which the development of the substantial contribution concept and associated criteria might prove impossible because a link between turnover or investments and the activity cannot be established. In these cases, a solution could be to apply the same social minimum safeguards in both taxonomies, namely UNGPs and OECD Guidelines, thereby ensuring that basic social standards are met.

As for coordination between the Social and the Environmental Taxonomy, there exist two main alternatives with a number of nuanced solutions in between. The first extreme alternative is to implement a single taxonomy according to which economic activities are considered sustainable insofar as they comply with both environmental and social requirements. The second opposite alternative is for regulators to set two independent taxonomies with no mechanisms in force to reconcile them, resulting in economic activities qualifying as environmentally sustainable even though they would be socially detrimental and *vice versa*.

[28] Id.

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Between these two extremes, the first option (so-called model 1) suggested by the PSF is that the Social and the Environmental Taxonomy be related only through social and environmental minimum safeguards, with governance safeguards applying to both. In this vein, the UN's guiding principles would serve as minimum safeguards for the environmental taxonomy, and the environmental part of the OECD Guidelines would serve as minimum safeguards for the social taxonomy. Furthermore, the respective social and environmental DNSH criteria would form the basis for detailed social and environmental criteria.

Meanwhile, the second option (so-called model 2) is to create a closer relationship between the two taxonomies. On these grounds, activities would be requested, on one side, to meet either at least one environmental or at least one social substantial-contribution requirement, and, on the other side, would have to meet all relevant environmental and social DNSH criteria.

5. Qualifications

a) Sector selection

Some sectors are particularly relevant for a given social objective. Sector selection would allow sectors to be prioritized for each social objective and sub-objective. Building on this argument, the PSF suggests using the NACE sector and economic activity-based framework.[29] The approach recommended is to: 1) identify priorities within the potential universe of economic activities (priority sectors); 2) identify and categorize opportunities to improve standards of human rights and workers' rights and access to products and services for basic human needs and basic infrastructure (priority economic activities); and 3) develop screening criteria based on technical work of and feedback from experts (Technical Screening Criteria).

b) Quantitative criteria

As in the environmental taxonomy, the indicators to measure substantial contribution of economic activities to social objectives can be linked to CapEx, OpEx, and turnover, and should also build on the distinction between addressing and avoiding negative impacts, on one side, and enhancing the positive impact inherent in an economic activity, on the other.

On these grounds, regarding activities purporting to reduce a negative impact, investments made to address and avoid

[29] Id.

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negative impacts might count as a social contribution. This could include expenditures for training personnel, as accounted for by OpEx.

For activities which substantially contribute to a social objective by enhancing their inherent social benefit, the relevant indicator should be the turnover resulting from the sales of that given social product or service.

Turnover should also be the key indicator for enabling activities.

c) Governance

Some implications of corporate governance might have a direct impact on sustainability. Accordingly, two objectives on governance with seven sub-objectives have been identified.

The first objective is "strengthening sustainability aspects of traditional corporate governance", and its two sub-objectives are: 1) sustainability-assessment skills in the highest governance body; and 2) transparency on sustainability objectives and targets.

The second objective is "strengthening corporate-governance aspects that are important for sustainability" and its five sub-objectives are: 1) anti-bribery and anti-corruption measurements; 2) responsible lobbying and political engagement; 3) transparent and non-aggressive tax planning; 4) diversity of board members; and 5) the option of employee representation on supervisory boards.

III. Assessing the Social Taxonomy

1. Strengths

While the environmental taxonomy was introduced in July 2020 through the Taxonomy Regulation, a similar classification system concerning socially-sustainable economic activities and investments has not been developed yet. The lack of such a system is regarded as an obstacle hindering the flow of investments toward socially-sustainable activities. Having no clear definition of the essential characteristics of social investments hinders their development and their potential contribution to solving social problems, where investors consider social investments as an opportunity, acknowledging that it is risky to ignore social factors when making investments. Importantly, this issue is not addressed by the environmental taxonomy where social and governance aspects are only a feature rather than the main focus.

The proposed social taxonomy would thus be a key classification system with the potential to harmonize measurement of social

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sustainability factors. Accordingly, investors could make informed and consistent decisions, directing resources towards socially-sustainable activities and companies.

The strengths of the proposed social taxonomy are outlined below.

a) Alignment with the Environmental Taxonomy

Firstly, the draft Social Taxonomy represents a necessary first step in advancing practical and granular social taxonomy design. In so doing, replicating, to some extent, the structure of the environmental taxonomy would ease the implementation phase and facilitate compliance with both taxonomies for investors. Accordingly, numerous reasons support the choice of aligning, insofar as possible, the two taxonomies. When both taxonomies are fully developed and operational, investors will be able to choose between investments with only social objectives, investments with only environmental objectives, and investments with both environmental and social objectives. If that is the final goal, then investors must be able to compare the extent to which an investment is considered aligned with the environmental taxonomy (only), with the social taxonomy (only), or with both.

Similarly, as companies are required to disclose data and information on both environmental and social issues, having two similar systems in place is expected to reduce the compliance burden.

From the policy perspective, since the EU environmental taxonomy has gained recognition even outside Europe, introducing a social taxonomy reflecting the structure of the former might allow the same goal(s) to be reached regarding social objectives as well.

b) Deviations from the Environmental Taxonomy

Along with structural similarities, there are also some deviations from the environmental taxonomy arising from the peculiarities of social objectives *vis-à-vis* environmental objectives.

Such peculiarities have been addressed through the designation of specific social objectives (and sub-objectives) which have been developed accounting for the stakeholders (workers, customers, and communities) who can be affected in social terms by economic activities. In other words, a sophisticated stakeholder-centric approach has been taken to cover the potential effects of economic activities on workers, customers, and communities.

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In addition, all economic activities bring some social benefits. Performing an economic activity creates, for instance, jobs and increases tax revenues thus providing so-called inherent social benefits. Such benefits cannot however be sufficient to qualify economic activities as socially sustainable. The design of the substantial contribution concept will then need to take into consideration the natural ability of economic activities to provide inherent social benefits and hence set more demanding requirements.

While the environmental taxonomy is built upon natural science data and considerations, which are also used to set thresholds and indicators for substantial contribution and DNSH, the social taxonomy has to be based on different foundations. The latter can be internationally-agreed rules and principles resulting from widespread global consensus. These rules and principles are typically incorporated in a number of important instruments with different levels of intrusiveness, legal force, and detail. Those identified by the PSF as a point of reference in this respect are: 1) the OECD Guidelines for Multinational Enterprises; 2) UN Global Compact Principles; 3) the principles and rights set out in the eight fundamental conventions identified in the Declaration of the International Labor Organization on Fundamental Principles and Rights at Work; 4) the International Bill of Human Rights; 5) the European Pillar of Social Rights; and 6) the European Social Charter.

2. Weaknesses

A social taxonomy naturally contains various weaknesses which might be difficult to overcome. This is especially the case for measuring the contribution of an economic activity to social objectives.

Moreover, the proposed social taxonomy presents some additional shortcomings resulting from mis-alignments with other legislative acts.

a) Measuring the contribution to social objectives

A key challenge for the development of a social taxonomy concerns the application of metrics to measure compliance with the substantial-contribution requirement and the DNSH principle. Currently, we lack quantifiable and precise indicators and metrics to measure both substantial contribution to social objectives and DNSH to other social objectives. In this regard, while some progress has been made recently through the creation of some social indicators, further efforts are needed to devise

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criteria for assessing the social impact of economic activities and investments.[30]

Quantitative metrics are important in that they would help provide clear outcome-oriented performance benchmarks rather than relying only on policy and procedural information that remain proxies for actual impacts. Unlike in the environmental taxonomy, the main difficulty in this respect arises from the scarcity of commonly utilized data-based metrics in the area of social sustainability. It should be recognized, though, that some quantifiable metrics have been developed for safe and healthy working conditions, anti-discrimination, freedom of association, and employment generation.

On this basis, applying criteria to develop reliable indicators to measure both substantial-contribution and DNSH requirements has been recommended. Indicators should refer to a norm, process, or goal in internationally-recognized standards. Such indicators should serve as good proxies for the objective they address. For example, the percentage of women sitting on a board of directors could be a reliable proxy for board diversity but not for non-discrimination in a company. They should also be specific enough to be linked to an economic activity and have a clear direction. For example, when evaluating complaint mechanisms, some questions should be asked, such as: is it good if there are many complaints, thus showing that workers trust the complaint mechanism? Or is it good if there are few complaints, because this would indicate that stakeholders cannot find issues to complain about? Investigation would be required to properly answer these questions. Moreover, indicators should be precise enough to avoid doubts on whether an activity fulfils them or not and they should all be similarly detailed. They should also avoid providing perverse incentives or unintended consequences, and data should be available at reasonable costs. Differences between larger and smaller companies should also be considered, and the principle of proportionality should apply.[31]

b) Mis-alignments within the EU Sustainable Finance Framework

Given the proposed structure of the social taxonomy and its objectives and sub-objectives, some mis-alignments with the SFDR and the Taxonomy Regulation as well as some weaknesses have been identified.

Social objectives and sub-objectives, as elaborated in the proposed social taxonomy, are not fully in line with those mentioned under Article 2(17) of the SFDR, which defines a socially-sustainable investment as ‘an investment in an

[30] See n 15.
[31] Id.

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economic activity that contributes to a social objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities.'

Furthermore, as in the environmental taxonomy, a social taxonomy should establish criteria to define socially-sustainable economic activities and investments. In this regard, it is essential to promote positive impacts on affected stakeholders and reach as many sectors as possible. At the same time, efforts should be made to prevent social washing. The need to further promote positive social impact while preventing social washing could be addressed by strengthening the minimum safeguards and integrating them with more stringent requirements to report on social impacts. Compliance with minimum safeguards is, however, required only for economic activities potentially eligible to qualify as socially sustainable and not to all economic activities. In order to extend stricter social reporting requirements to more sectors, it could be necessary to advance the discussion on the amendment and integration of other rules on non-financial reporting.

While social objectives should be defined to set the criteria for substantial contribution, references to basic human needs and infrastructure are made in the proposed social taxonomy objectives. Improving the accessibility of products and services for basic human needs and infrastructure seems to relate more to the minimum safeguard requirement, which is well short of the ambitions of the Taxonomy Regulation.

With the proposed structure, only two activities will be identified: activities aligned to the social taxonomy (and enabling activities), thus qualified as sustainable; and activities not meeting the requirements of the social taxonomy, and thus not qualifying as sustainable irrespective of their potential contribution to social objectives. Such an approach might not fully consider and reward economic activities that, despite still failing to meet the demanding requirements under the taxonomy, have taken the right direction and might eventually become socially sustainable. Such a "winner takes all" approach might ultimately fail to consider the positive impact that some economic activities can also have in social terms irrespective of them not meeting the substantial-contribution requirement (yet). This could be the case for transitional and mitigating economic activities the performance of which might be beneficial even from the social perspective. A more granular approach should then be developed to incentivize such activities rather than disregarding or even penalizing them.

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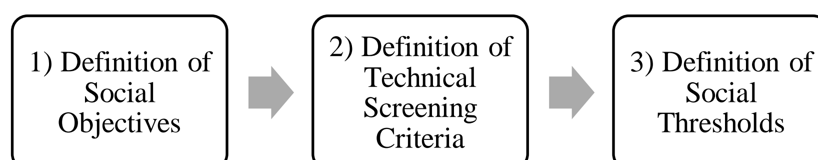
IV. A 3-step Scorecard Approach to a Social Taxonomy

1. Suggested Model

To contribute to the debate on how to develop an EU social taxonomy able to recognize and incentivize every economic activity (and investment thereof) pursuing social sustainability, we propose herein a three-step-approach building on the definition of socially-sustainable investment under Article 2(17) of the SFDR and largely aligned with the structure of the environmental taxonomy.

Accordingly, while social objectives could be determined in accordance with Article 2(17) of the SFDR, specific technical screening criteria for socially-sustainable economic activities could be developed (as was done for environmentally-sustainable economic activities) and then a scoring system might be established to set thresholds and verify the achievement (or partial achievement) of one or more social objectives. This would allow us to distinguish between substantial contribution to a social objective, contribution to a social objective (which could also be relevant under Articles 8 and 9 of the SFDR), socially-neutral contribution, and harmful impact.

Figure 1: 3-step Scorecard Approach to a Social Taxonomy



First Step: Social Objectives based on Art. 2(17) SFDR

The formulation of social objectives should be in line with Article 2(17) of the SFDR and follow its structure. Accordingly, it would be possible to avoid the introduction of an entirely new system since, to comply with the SFDR obligations, financial service providers and investors have already started implementing social sustainability factors. The alignment of social objectives with internationally-recognized standards and guidelines, as shown in table 4, needs to be ensured for consistency in the application of social factors.[32]

[32] On this see Dirk A. Zetzsche, Marco Bodellini and Roberta Consiglio, The EU Sustainable Finance Framework in light of International Standards, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3984511.

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Table 4: Social Objectives under Article 2(17) of the SFDR and International Standards

Article 2(17) of the SFDR	**International Social Standards of Reference**
Tackling inequality	IFC 1, International Bill of Human Rights; UN business and human rights principles; OECD chapter IV; UNGC 1,2; SDGs 1, 2, 3, 4, 5, 10.
Fostering social cohesion	IFC 1, 2, 4, 5, 7, 8; UN business and human rights principles; UNGC 1,2; OECD chapter IV, V, VIII, IX; SDGs 1-12.
Fostering social integration	IFC 1, 4, 7;3, 4, 5, 6; UNGC 1,2; OECD chapter IV, IX. SDGs 4, 5, 9, 10.
Fostering labor relations	IFC 2; UN business and human rights principles; ILO on Fundamental Principles and Rights at Work UNGC 3,4,5,6; OECD chapter V; SDGs 8,9.
Furthering investment in human capital	IFC 2, 4; ILO on Fundamental Principles and Rights at Work; OECD chapter V.
Furthering investment in economically or socially disadvantaged communities	IFC 4, 7; SDG 11.

On the basis of Article 2(17) of the SFDR, such social objectives would then cover the following six major dimensions laid out in table 4: 1) tackling inequality; 2) fostering social cohesion; 3) fostering social integration; 4) fostering labor relations; 5) investment in human capital; and 6) investment in economically- or socially-disadvantaged communities.

Such social dimensions are coherent with the OECD Guidelines for Multinational Enterprises,[33] the IFC Performance Standards on Environmental and Social Sustainability, the UN Global Compact Principles[34] and the SDGs.[35] More detailed sub-objectives would need to be developed by ensuring necessary linkages with Article 2(17) of the SFDR and international standards on sustainability.[36]

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[33] OECD, GUIDELINES FOR MULTINATIONAL ENTERPRISES, www.oecd.org/corporate/mne/.

[34] UN Global Compact, *The Ten Principles of the UN Global Compact*, www.unglobalcompact.org/what-is-gc/mission/principles.

[35] SDGs, https://sdgs.un.org/goals.

[36] In this regard some useful references can be found in the Universal Standards for Responsible Inclusive Finance. The Universal Standards are considered ‘the most comprehensive manual of best practices created by and for people in microfinance as a resource to help financial service providers

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Second Step: Technical Screening Criteria for Socially-sustainable Economic Activities

Similar to the environmental taxonomy, technical screening criteria should be established to determine the extent to which an economic activity contributes to one or more social objectives.

As technical screening criteria need to be measurable, metrics should be introduced and linked to each social objective to provide quantitative measures of their level of attainment. Reliable social metrics can be searched for in academic scholarship and industry frameworks. While a few academic studies deal with the mapping and assessment of the 'S' dimension of ESG factors, several market players have been measuring this for a long time.

Market operators extensively use social and impact measurement systems as part of sectorial social performance management or ESG ratings and certifications. Sectorial social performance management tools are very common among microfinance and impact investors.[37] The latter consider social factors within the broader concept of impact.[38] Specific examples of metrics and indicators include the Global Impact Investing Network (GIIN)'s IRIS Catalogue of Metrics,[39] Harmonized Indicators for Private Sector Operations (HIPSO),[40] and OECD FDI Qualities Indicators.[41]

In this respect, one of the most relevant tools is the CERISE Social Performance Indicators 4 (SPI4), which is 'a social audit tool for microfinance providers.'[42] Through a questionnaire, the SPI4 helps financial service providers measure their alignment with the Universal Standards for Social Performance Management.[43]

Meanwhile, market operators heavily rely upon ESG ratings. Interest in developing ESG ratings has considerably increased in the last decade and the main rating agencies have stepped into the market of ESG assessment by acquiring key players.[44] ESG

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achieve their social goals'; https://sptf.info/universal-standards-for-spm/start-here.

[37] Michal Shinwell and Efrat Shamir, *Measuring the impact of businesses on people's well-being and sustainability OECD*, Working paper No. 2018/08 (2018).

[38] EVPA, A Practical Guide to Measuring and Managing Impact (2015).

[39] GIIN, *IRIS Catalog of Metrics,* https://iris.thegiin.org/metrics/?search=&sortby=alphabetical.

[40] HIPSO, *Indicators,* https://indicators.ifipartnership.org/indicators/.

[41] OECD, FDI Qualities Indicators: Measuring the sustainable development impacts of investment (2019), www.oecd.org/fr/investissement/fdi-qualities-indicators.htm.

[42] SPTF, Assess and Plan, https://sptf.info/universal-standards-for-spm/assess-and-plan.

[43] SPTF, Universal Standards for Responsible Inclusive Finance.

[44] SustainAbility, Rate the Raters 2020: Investor Survey and Interview

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ratings are the most relevant source of ESG information for investors and are commonly understood as score-based evaluations of companies that provide an assessment of performance on ESG issues. Most of them provide one unique score summarizing corporate performance on ESG issues. Therefore, social metrics or scores are commonly used as part of ESG rating models, with many of them relying on a weighted average approach.

Still, two major shortcomings characterize ESG ratings: a common lack of transparency in disclosing rating models by rating agencies[45]; and some major divergences on evaluating sustainability that can lead to conflicting outcomes.[46] The importance of ESG ratings along with their weaknesses are also mentioned in the EU SFAP 2018, where it is outlined that the efforts of rating agencies to assess companies' ESG performance and their ability to manage sustainability risks have increased lately.[47] Against this background, the Commission emphasizes that such assessments are important in that they improve the flow of sustainability-related information between issuers and investors, thereby facilitating a more sustainable allocation of capital.[48] However, due to the absence of broadly-accepted standards to assess companies' sustainability performance, information on the methodology used by rating agencies becomes crucial to enable consistency and thereby comparability. The other issue raised by the Commission is that typically only large issuers are assessed by rating agencies, leaving numerous businesses unassessed.[49]

It remains unclear if and to what extent sustainability factors are being considered by rating agencies, so the Commission monitors developments in the credit rating market and acknowledges the need for greater transparency on how rating agencies handle sustainability factors. Based on this, the

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Results, March 2020) www.sustainability.com/globalassets/sustainability.com/thinking/pdfs/sustainability-ratetheraters2020-report.pdf.

[45] Kotsantonis and Serafeim, *Four things No One Will Tell You About ESG Data*, 31 JOURNAL OF APPLIED CORPORATE FINANCE 50; Gregor Dorfleitner, Gerhard Halbritter and Mai Nguyen, *Measuring the level and risk of corporate responsibility – An empirical comparison of different ESG rating approaches*, 16 J. ASSET MANAG. 450, 465 (2015); Florian Berg, Kornelia Fabisik and Zacharias Sautner, *Rewriting History II: The (Un)predictable Past of ESG Ratings*, ECGI, FINANCE WORKING PAPER N° 708/2020, November 2020, http://ssrn.com/abstract_id=3722087.

[46] Timothy M. Doyle, *Ratings that don't rate. The subjective view of ESG rating agencies*, ACCF AMERICAN COUNCIL FOR CAPITAL FORMATION (Jul. 2018), https://bit.ly/2LBwvky; Doni F. and Johannsdottir L., *Environmental Social and Governance (ESG) Ratings*, in Leal Filho W., Azul A.M., Brandli L., Özuyar P.G., Wall T. (eds) CLIMATE ACTION. ENCYCLOPEDIA OF THE UN SUSTAINABLE DEVELOPMENT GOALS (Springer, Cham), 435-449 (2019).

[47] See n 2.

[48] Id.

[49] Id.

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Commission invited ESMA to advance solutions ensuring that credit rating agencies fully integrate sustainability and long-term risks in their assessments.[50]

[50] Id.

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Table 5: ESG rating providers measuring sustainability factors

	Bloomberg ESG Disclosure Score	FTSE Russell's ESG Ratings	MSCI ESG Ratings	Fitch ESG Relevance Scores
Air Quality	✔			✔
Climate Change	✔	✔	✔	
Water & Energy Management	✔	✔		✔
Materials & Waste, Health & Safety	✔	✔		
Audit Risk & Oversight	✔			
Compensation	✔			
Diversity	✔			
Board Independence	✔			
Structure & Tenure	✔			
Shareholders' Rights	✔			
Biodiversity		✔		
Pollution & resources		✔	✔	
Customer Responsibility		✔		
Human rights and community		✔		✔
Labor standards		✔		✔
Anti-corruption		✔		
Corporate governance		✔	✔	
Risk management		✔		
Tax transparency		✔		
Natural capital			✔	

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Environmental opportunities			✔	
Human capital			✔	
Product liability			✔	
Stakeholder opposition			✔	
Social opportunities			✔	
Corporate behaviour			✔	
Waste and hazardous materials management				✔
Ecological impacts				✔
Exposure to environmental impacts				✔
Customer welfare - fair messaging;				✔
Privacy & data security				✔
Employee wellbeing;				✔
Exposure to social impact				✔
Environmental impacts				
Relations with customers & suppliers				
Stakeholder engagement				
Board practice & structure				
Codes of ethics				
ESG risk management				
Board-level responsibility for stakeholders				
Board-level gender diversity				
Allegations of bribery & corruption				

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Third Step: Social Thresholds

Technical Screening Criteria for determining the extent to which an economic activity contributes to a social objective should also refer to thresholds or performance levels that such an activity should meet. Therefore, a scoring system could consider: a) as 'socially harmful' an activity (and in turn investments therein) with a score between 0-1; b) as 'socially neutral' an activity (and in turn investments therein) with a score between 2-3; c) as 'socially beneficial' an activity (and in turn investments therein) with a score between 4-7; and, d) as 'socially positive' an activity (and in turn investments therein) with a score between 8-10. Only activities scoring between 8-10 would then be qualified as socially-sustainable economic activities under the taxonomy and investments funding them would accordingly be qualified as socially sustainable. Yet, most activities could obtain a score between 4-7 by providing a meaningful (though not substantial) contribution to social objectives. Such activities (and investments funding them) should be recognized within the legal framework. In other words, it would be sensible to provide an incentive for economic activities to increase progressively their social contribution on the grounds that not every activity can meet high social thresholds overnight.

From a policy perspective, the creation of a middle-level category of economic activities with the ability to further social sustainability, despite still being unable to meet more demanding requirements, is an effective way to encourage market sustainability competition.

Further research is needed to develop such a model, yet it would be reasonable to believe that an orientation towards the United Nation's SDGs would find acceptance among the most socially-oriented investors. Such a granular approach would allow for sectorial investments (e.g. investments furthering financial inclusion).

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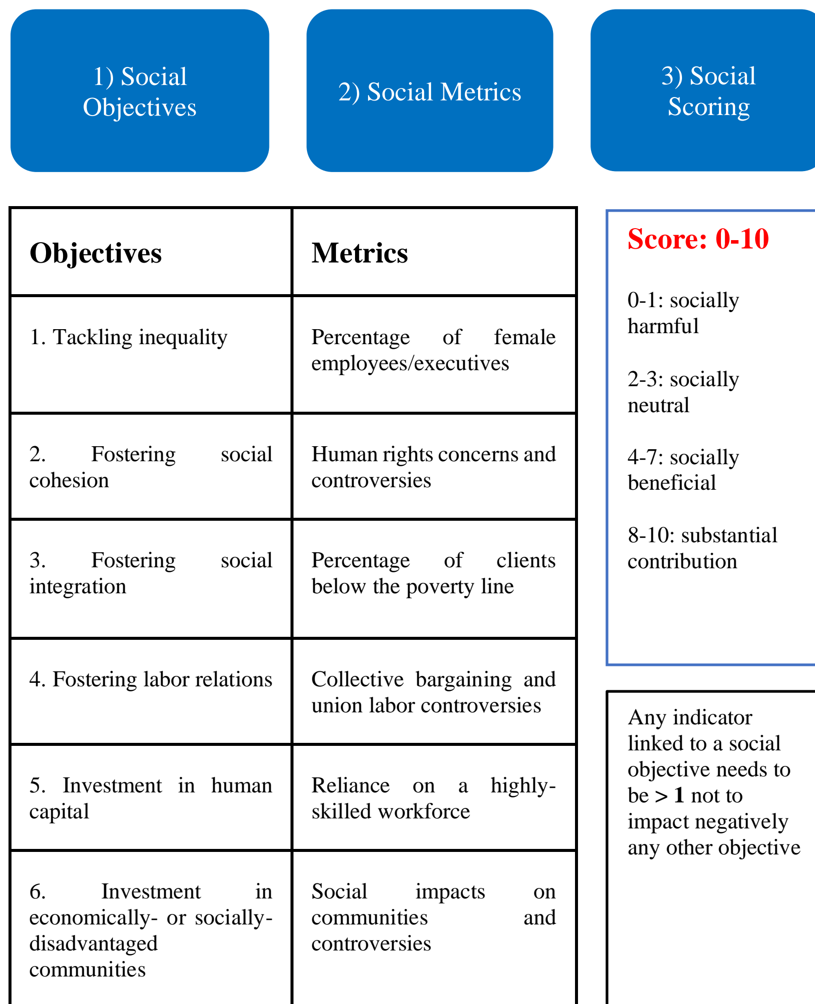
Figure 2: Scoring system



Objectives	**Metrics**
1. Tackling inequality	Percentage of female employees/executives
2. Fostering social cohesion	Human rights concerns and controversies
3. Fostering social integration	Percentage of clients below the poverty line
4. Fostering labor relations	Collective bargaining and union labor controversies
5. Investment in human capital	Reliance on a highly-skilled workforce
6. Investment in economically- or socially-disadvantaged communities	Social impacts on communities and controversies

2. From Theory to Practice

Some examples may provide greater insights on how our scorecard approach may function for each objective defined in the Social Taxonomy.

On tackling inequality, the legal framework of several jurisdictions sets a minimum percentage for female board membership of large companies. A balanced composition where both males and females are represented on boards is assumed to further effective discussion and exchange of views in the board room, resulting in better decision-making. The same principle could be expanded to senior management. In our scorecard approach, activities performed by companies with boards with a greater share of female members and key executives receive a higher score.

On social cohesion, the focus is on respect of human rights of employees (in the work context) and customers (in the sales context). In this regard, the number of informal disputes and lawsuits could provide an indicator to measure the company's

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performance: the lower the number of disputes, the higher the score.

On social integration, a sensible metric could be based on the percentage of the company's clients below the national definition of poverty or vulnerable parts of the population (disabled, immigrants). A high score indicates a high level of social integration.

On labor relations, collective bargaining and union labor controversies could feed into the score.

On investment in human capital, a good metric could consider the expenditure in staff training, whereby the higher the percentage the better the company's score.

On economically- or socially-disadvantaged communities, the company's score could be based on the company's investments in a given area specified by the national government.

In the following section we apply our scorecard approach to a hypothetical microfinance fund.

Step 1

A microfinance fund has as an investment objective "poverty reduction through the provision of short and medium-term financing to microfinance institutions in emerging markets". Such an objective is in line with the sub-objective "promoting equality and inclusive growth". As such, we can assume that microfinance investments potentially qualify as a socially sustainable economic activity.

Step 2

As argued above, to avoid *social washing* a given set of metrics should be set to verify the level of attainment of the investment objective. Relevant social metrics in line with such objective could be: 1) outreach (the number of final borrowers reached by the microfinance fund funding): 2) median loan amount per borrower; and 3) percentage of women as final borrowers.

Step 3

The thresholds for those metrics could be: 1) 500,000 final borrowers; 2) median loan amount: 2,000$; 3) 70% women final borrowers.

As a result of data collection, final scores could be respectively 1) 510,000 final borrowers reached by the fund; 2) median loan amount: 2,450$; 3) 80% of women being final borrowers.

As the metric 1) would be higher than the set threshold, the score obtained would be 4 (socially beneficial); 2) as the median loan amount would be slightly higher than the set threshold, the score obtained would be 2 (socially neutral); 3) with 80% of women

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borrowers, a score of 10 would be obtained (substantial contribution).

While such investment in microfinance could result in a classification as socially neutral, from an overall perspective, given its low score in the second category, our scorecard approach would allow targeted investment by investors seeking to further gender equality. This result reflects that social missions are often partial, rather than all-encompassing, and allows for mission-based investments.

3. SWOT Analysis of the Scorecard Approach

The scorecard approach presented herein has both advantages and downsides.

a) Strengths

The main advantage would be that such an approach could help tackle the major weakness affecting a Social Taxonomy, namely the difficulties of precisely measuring the contribution of an economic activity to social objectives. A scoring system based on objectives and inherent metrics could enable measurement of the degree of contribution to social objectives made by any given economic activity.

This in turn would allow for the building of a more granular measurement system whereby every economic activity could be precisely assessed against its contribution to social objectives. Accordingly, the "winner takes all" approach of the proposed Social Taxonomy could be overcome in favor of a more sensible regulatory treatment which would be capable of recognizing the positive impact that economic activities can have in social terms, irrespective of them not meeting the substantial-contribution requirement. This could be, for instance, the case of transitional and mitigating economic activities whose performance might be beneficial even from the social perspective.

b) Weaknesses

In practical terms, it would not be simple to decide who should be empowered to assign social scores to economic activities on the basis of their measured contribution to social objectives. Certainly, some broad criteria could be developed, but for this to work a legislative initiative would be needed. Moreover, in order for the system to be granular enough, detailed and lengthy level 2 legislation might be required. Yet, even with detailed level 2 legislation in force, an authority in charge of providing economic activities with a social score would still be needed and no authority with the necessary combination of sophisticated social, economic, business, and financial skills currently exists in the EU.

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To avoid the need to draft detailed level 2 legislation and empower an authority to assign social scores to economic activities, an alternative could be to design an automated system whereby any business could enter data and information concerning its activities and organization, from which the system could calculate a score. Yet, such an automated system could function only if the underlying algorithm was designed on the basis of metrics against which economic activities should be assessed. For transparency, such metrics should be publicly available.

Yet, irrespective of its design and ways of working, it seems to us that the advantages of such a scorecard approach would exceed the disadvantages, and therefore an argument can be made in favor of embedding it in the proposed social taxonomy.

4. Policy Considerations

The EU Social Taxonomy seeks to fill a gap stemming from the fact that the EU legal framework currently lacks stipulations and disclosure requirements for socially-sustainable investments.[51]

Yet, policy-makers could take into consideration the introduction of a three-step-approach, as outlined above, with a view to framing a social taxonomy in line with Article 2(17) of the SFDR.

The first step would be to determine social sustainability objectives in line with Article 2(17) of the SFDR. The second step would be the definition of technical screening criteria for socially-sustainable economic activities, including the creation of social metrics, which should be linked to each social objective. The third step would be the establishment of a scoring system with some specific thresholds to verify the extent to which economic activities contribute to one or more social objectives. Such an approach is more likely to be acceptable for financial market participants, many of whom have already been taking into consideration social sustainability factors.

The metrics to be introduced should be linked to each social objective to provide quantitative thresholds relating to the level of attainment of such objectives. Several social metrics have already been developed and are commonly utilized. Although there are two major shortcomings characterizing ESG ratings, namely a lack of transparency and divergences in evaluating sustainability, these tools could be refined and made fit for purpose.

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[51] Dirk A. Zetzsche, Marco Bodellini and Roberta Consiglio, The EU Sustainable Finance Framework in light of International Standards, JIEL forthcoming, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3984511.

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On the basis of the first two steps, the proposed scoring system could then lead to the classification of investments, ranging from 'socially harmful' to 'socially positive.' A more granular approach would indeed allow for sectorial promotion investing (e.g. impact investments), since under the current framework players like microfinance funds targeting certain social objectives (*e.g.* financial inclusion) would likely disguise such objectives as environmental objectives.

When developing a social taxonomy, policy-makers should look into impact investments and their scoring systems to evaluate social factors. It should also be ensured that socially-sustainable investments are not assumed to be the same as *unprofitable* investments.

In addition, reliable data should be produced before mandating social taxonomy compliance. Experience gained in relation to the Taxonomy Regulation should have increased awareness that regulating uncharted territory comes with unforeseen challenges for all market actors.[52]

It is also essential that enhanced harmonization and coordination of European policies and international standards on sustainability are achieved.[53] Lack of coordination in terms of timing in the implementation of ESG disclosure and reporting policies at issuer level and at financial market participant level may generate uncertainty about what to disclose. For a reliable and comparable reporting system on sustainability at the financial market participant level, it is indeed necessary to obtain standardized forms of disclosure on sustainability from issuers in the first place. Specifically, financial service providers would need information on the environmental and social impacts of companies they invest in to meet their disclosure requirements under the SFDR.[54] Such information on corporate sustainability is currently neither always available, nor standardized. In turn, at the issuer level, some companies are required 'to report on the extent to which their activities are sustainable' under Article 8 of the Taxonomy Regulation and in accordance with the Technical Screening Criteria.[55] Sustainability reporting standards for companies are currently spread across different legislative acts (some of which are still at the proposal stage). Most probably,

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[52] See Dirk A. Zetzsche & Linn Anker-Sørensen, *Regulating Sustainable Finance in The Dark*, European Business Organization Law Review, 2022.

[53] See n 7; also IOSCO, REPORT ON SUSTAINABILITY-RELATED ISSUER DISCLOSURES, June 2021, at 31.

[54] European Commission, *Questions and Answers: Corporate Sustainability Reporting Directive proposal*, ec.europa.eu/commission/presscorner/detail/en/qanda_21_1806.

[55] Id.*;* see also EU Taxonomy Climate Delegated Act, Annex I (Climate Change Mitigation) and Annex II (Climate Change Adaptation), C(2021) 2800 final, Annex 1 C(2021) 2800 final, Annex 2 C(2021) 2800 final, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=PI_COM:C(2021)2800.

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adequate sustainability reporting will be achieved only when the first set of standards on sustainability reporting for companies is adopted. Overall, the main shortcomings here are self-reporting and the lack of harmonized standards. This may encourage reporting 'at all costs,' which can result in inaccurate reporting or, even worse, in furthering green washing and social washing, running counter to the first objective of the EU's sustainable finance legal framework.[56] Regulators are currently devising solutions to enhance the consistency of the EU's sustainability reporting standards. A roadmap has been developed by a multi-stakeholder task force established by the European Financial Reporting Advisory Group (EFRAG)[57] and a new Strategy for Financing the Transition to a Sustainable Economy has been published.[58] Furthermore, harmonization is necessary not only within the EU's sustainable finance legal framework but also at international level: it is in 'the interest of the EU and European companies and investors to have standards that are globally aligned.'[59]

Coordination is also paramount with regard to the development of policies on the disclosure of social factors. In particular, a social taxonomy should be finalized within the current sustainable finance framework and should consider the current legislative developments on directors' duties and supply-chain due diligence.[60] While the adoption of mandatory due-diligence requirements at EU level could enhance harmonization with international standards and legal certainty, it could also result in higher compliance costs for businesses due to a lack of harmonization with current and prospect legislative and regulatory initiatives (*i.e.,* the SFDR, the Taxonomy Regulation, and the potential future social taxonomy).

In a similar fashion, if and when a social taxonomy is adopted, then its coordination with the environmental taxonomy will be crucial. Indeed, it will be key for investors to understand the

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[56] Marco Bodellini and Dalvinder Singh, Sustainability and finance: utopian oxymoron or achievable companionship?, in Law and Economics Yearly Review, 2021, 169-170.

[57] EFRAG, EU REPORTING LAB, PROPOSALS FOR A RELEVANT AND DYNAMIC EU SUSTAINABILITY REPORTING STANDARD SETTING, ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/210308-report-efrag-sustainability-reporting-standard-setting_en.pdf.

[58] See n 7.

[59] Id.

[60] European Parliament, Corporate due diligence and corporate accountability, P9_TA(2021)0073, www.europarl.europa.eu/doceo/document/TA-9-2021-0073_EN.pdf; see also Afore Consulting, *Moving towards a Social Taxonomy: The challenge of International Supply Chains*, https://events.aforeconsulting.eu/events/moving-towards-a-social-taxonomy-the-challenge-of-international-supply-chains/.

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extent to which investments comply with the environmental taxonomy only, with the social taxonomy only, or with both.

V. Conclusion

This paper has analyzed the draft Social Taxonomy proposed by the Platform for Sustainable Finance in early 2022. Based on an analysis of the proposal's strengths and weaknesses, we challenge the decision to follow the methodology employed in the Taxonomy Regulation. In particular, we take issue with the "winner takes all" character of the proposed Social Taxonomy, as this methodology seems to fail to properly incentivize transitional and mitigating economic activities which are of particular importance in light of the ambiguity of social standards and expectations.

In order to incentivize the transition and avoid additional taxonomies for transitional and mitigating activities, this paper has proposed an alternative scorecard approach which assigns low scores for transitional and mitigating activities and high scores for activities meeting strict criteria under the taxonomy system.

Electronic copy available at: https://ssrn.com/abstract=4218874